



THE CITY OF SAN DIEGO
MANAGER'S REPORT

DATE ISSUED: March 28, 2003 **REPORT NO.** 03-060

ATTENTION: The Committee on Rules, Finance and Intergovernmental Relations

SUBJECT: City Manager's Proposal Regarding Budget Principles

REFERENCE: Blue Ribbon Committee Report on City of San Diego Finances – February 2002

Memorandum from Mayor Murphy to San Diego City Council on Blue Ribbon Committee Recommendations/Rules Committee Actions – April 4, 2002

SUMMARY

Issue - Should the Committee on Rules, Finance and Intergovernmental Relations adopt the following recommendations regarding budget principles as recommended by the Blue Ribbon Committee Report and proposed by the City Manager?

1. Follow the City's existing Budget Principles.
2. Revise Budget Principle #2 – The General Fund Reserve should be maintained at a minimum of 3% of General Fund revenues, with the goal of bringing General Reserves to a level that is 7% of General Fund revenues, which includes the goal of bringing the General Fund Reserve to 5% of General Fund revenues within 10 years (by Fiscal Year 2014). The General Fund Reserve should be increased by at least 10% of any General Fund revenue increase in excess of 2% in any fiscal year in which General Fund revenues increase by more than 2% over the prior year budgeted revenues, until the 5% goal is achieved.

3. Add Proposed Budget Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the City Manager and adopted by the City Council.
4. Add Proposed Budget Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.

Manager's Recommendation - Adopt the following changes to the existing budget principles as recommended by the Blue Ribbon Committee and proposed by the City Manager:

1. Follow the City's existing Budget Principles.
2. Revise Budget Principle #2 – The General Fund Reserve should be maintained at a minimum of 3% of General Fund revenues, with the goal of bringing General Reserves to a level that is 7% of General Fund revenues, which includes the goal of bringing the General Fund Reserve to 5% of General Fund revenues within 10 years (by Fiscal Year 2014). The General Fund Reserve should be increased by at least 10% of any General Fund revenue increase in excess of 2% in any fiscal year in which General Fund revenues increase by more than 2% over the prior year budgeted revenues, until the 5% goal is achieved.
3. Add Budget Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the City Manager and adopted by the City Council.
4. Add Budget Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.

Other Recommendations – None.

Fiscal Impact – The fiscal impact of adhering to revised Budget Principle #2 in Fiscal Year 2004, assuming a conservative increase of 2% in General Fund revenues, would require a minimum increase to the General Fund Reserve of approximately \$900,000 to maintain the General Fund Reserve at 3% of General Fund revenues. The fiscal impact of adding Proposed Budget Principle #7 is unknown as the scope of the strategic budget plan has not yet been defined. There is no fiscal impact associated with adding Proposed Budget Principle #8.

BACKGROUND

During Fiscal Year 1998, the City Manager proposed and the Rules Committee conceptually endorsed the existing six principles of budgeting and finance. The principles were first used in developing the budget in Fiscal Year 1999.

As endorsed by the Rules Committee, the six budget principles currently being used in the fiscal year budget development are:

1. Ongoing expenditures should be supported by ongoing revenues. Accordingly, onetime revenues should not be used for ongoing expenditures on a continuous basis.
2. [As revised by City Council, October 14, 2002] The General Fund Reserve should be maintained at a minimum of 3% of the General Fund revenues with the goal of bringing General Reserves to a level that is 7% of General Fund revenues, which includes the goal of bringing the General Fund Reserve to 5% of General Fund revenues within 10 years (by Fiscal Year 2014). The General Fund Reserve should be increased by at least 10% of the General Fund revenue increase in excess of 2% in any fiscal year in which General Fund revenues increase by more than 2% over the prior year budgeted revenues until the 5% goal is achieved.
3. When capital projects are considered, all associated costs should be identified in order to properly assess future financial impacts.
4. Each enterprise fund should reflect the true cost of operation, including direct and indirect costs of services provided by the General Fund.
5. Activities that are supported by user fees should be fully cost recoverable.
6. Discretionary General Fund revenues should not be earmarked, thereby allowing maximum flexibility in funding decisions on an annual basis.

The Blue Ribbon Committee Report recommended that “the City should follow its existing six budget principles and add two additional budget principles:

Proposed Budget Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the Manager and adopted by the Council.

Proposed Budget Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.”

The Blue Ribbon Committee Report supports the existing six budget principles. The report recommended revising Budget Principle #2: *the General Fund Reserve should be maintained at approximately three percent*, to reflect that the General Reserves be maintained at 7% to 10%. On October 14, 2002 the City Council adopted a proposal to maintain the General Fund Reserve at a minimum of 3% of General Fund revenues and establish a goal to bring the General Fund Reserve to 5% of General Fund revenues within 10 years (by Fiscal Year 2014). The Council also adopted a proposal to establish a goal of maintaining the General Reserves to a level that is 7% of General Fund revenues.

In regard to Proposed Budget Principle #7, the Blue Ribbon Committee Report stated:

Addressing large capital project needs and long-term population growth require the City to have a multiple year approach to providing and funding municipal services. Development of a strategic plan for the City of San Diego would help citizens and their elected representatives better understand the public policy choices and investments required to maintain our quality of life, and offers an

assurance that important long-term priorities are not lost among urgent year to year decision making. Further, strategic plans offer all parties an important opportunity to debate what San Diego should look like in the future years. For purposes of better framing important public policy decisions, identifying long term City service and revenue needs, assuring attention to long term priorities, and accomplishing the highest and best uses of City tax dollars, the Committee calls on the City Manager to prepare, and the Mayor and Council to adopt, a San Diego Fiscal Strategic Plan.

The Blue Ribbon Committee Report also mentioned the benefits of a long term strategic plan with regard to Budget Principle #3: *When capital projects are considered, all associated costs should be identified in order to properly assess future financial impacts*, and Budget Principle #6: *Discretionary General Fund revenues should not be earmarked, thereby allowing maximum flexibility in funding decisions on an annual basis*.

In regard to Proposed Budget Principle #8, the Blue Ribbon Committee Report stated:

Sound financial and organizational management techniques dictate that once adopted, budgets should be changed only when urgently needed. When urgent circumstances, such as natural disasters or unforeseen economic slumps occur, it is imperative that specific funding be identified to accompany new priorities. Without such clarity, the legal obligation to provide a balanced budget cannot be honored, nor can spending priorities be recalibrated in the public setting taxpayers deserve. The Committee also notes that frequently changing priorities can increase the cost of City administration.

In a memorandum from Mayor Murphy to the City Council on Blue Ribbon Committee Recommendations/Rules Committee Actions dated April 4, 2002, the Mayor directed the City Manager to prepare a proposal to the Committee on Rules, Finance and Intergovernmental Relations to adopt the Blue Ribbon Committee Report recommendation to follow the City's existing six budget principles and add the two additional budget principles.

DISCUSSION

With the exception of the Library Ordinance's impact on Budget Principle #6 (City Manager shall propose that the Library receive a budget that is equal to incrementally increasing percentages of the General Fund budget until it reaches 6% in Fiscal Year 2005), the Blue Ribbon Committee Report found that the existing six budget principles are being followed. The only change suggested in the Blue Ribbon Report was to Budget Principle #2, which was revised by the City Council on October 14, 2002.

Proposed Budget Principle #7: Budget development should be guided by a long term, or strategic budget plan proposed by the Manager and adopted by the Council.

The Government Finance Officers Association (GFOA) has endorsed the recommended practices for state and local budgeting developed by the National Advisory Council of State and Local Budgeting (NACSLB) in *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting*. Among these recommended budget practices is development of a

long term, or strategic budget plan. The GFOA recommends the establishment of broad goals to guide government decision-making, development of management strategies and the budget in a manner which allows government to achieve long-range goals, and development of a long-range financial plan to ensure that programs, services, and projects are affordable in the future. Long-range financial plans and projections should be developed, updated, and reviewed, and those plans and projections should be used to guide the budget-development decision-making process.

One of the GFOA's examples of this budget principle is the City of Glendale, Arizona's Strategic Financial Plan. The purpose of Glendale's Strategic Financial Plan is to identify financial mechanisms to respond to revenue fluctuations with minimal impact on service level and quality. The intention is to respond proactively to financial changes and be as prepared as possible to deal with the unexpected. The city's Strategic Financial Plan includes both long and short-term strategies to maximize the city's flexibility in responding to change. Long-term strategies include adjusting staff levels and alternatives to permanent staff increases, equalizing predictable expenses over multiple budget years, and capital improvement plan schedule development. Short-term strategies include sales tax stabilization, operating capital management, and building and maintaining adequate contingency reserves. Development of the Strategic Financial Plan includes using a computer simulation model to analyze the potential impacts of different variables on the city's financial stability as well as evaluate the benefits and shortcomings of possible long and short-term strategies. The Strategic Financial Plan is updated annually and is used in conjunction with the city's Five-Year Forecast and Glendale Financial Policies to guide budget development.

One of the benefits of a strategic budget plan is in having established priorities to assist in budget-related decision-making. Discussion of budget priorities would take place in a public forum, allowing citizens and the Mayor and City Council to assess long-term goals for the City. These priorities would aid the City Manager in preparing the proposed budget, and aid the Mayor and City Council in adopting the final budget, by following the priorities and future budget requirements established in the strategic budget plan.

Additionally, a strategic budget plan would emphasize the projection of future revenues versus future expenditures. Projections would take into account future needs based on population growth as well as spending priorities. A comparison of projected revenues to anticipated expenditures would help the City to be proactive in dealing with future cash flow problems. Projected revenue shortfalls and/or expenditure deficits could be addressed earlier in the budget process. Alternative sources of revenue could be discussed and implemented before the shortfall occurs to avoid expenditure cuts. Conversely, expenditures could be evaluated and resources reallocated to meet priorities in lieu of increasing revenues.

The City of San Diego is already utilizing several strategies and processes that reflect the intent of Proposed Budget Principle #7, while retaining the decision-making flexibility that is required due to the dynamic nature of both the City itself and its revenue sources.

On October 22, 2002, the City Council adopted the Strategic Framework Element as an update to the General Plan. The Strategic Framework Element represents the City's new approach to shaping the growth of the City; as such, any new programs, enhancements to existing services, or new development must be consistent with the Strategic Framework.

The City's Capital Improvements Program Budget is an eleven-year budget, which provides a long-range perspective on the City's capital improvement plans, as well as identifying unfulfilled funding requirements well into the future. This enables City management to view planned future capital expenditures and adjust as necessary to meet anticipated City needs, as well as giving them the ability to strategize for future funding requirements well in advance of project initiation.

A five-year expenditure forecast is completed for each department as part of the Operating Budget. The five year expenditure forecast includes an inflation rate as well as adjustments based on departments' specific needs into the future.

The Mayor's 10 Goals and the priorities of each City Councilmember are used to set budget priorities. Additional input for the budget is provided by the Mayor and City Council at budget workshops prior to establishment of the proposed budget. Citizen input is provided through continuous departmental customer surveys and Community Budget Forums where the City Manager and Council Members discuss the budget with various community groups.

While a strategic budget plan can focus attention on future issues, it is best as a high-level, flexible plan for the future due to unanticipated situations that could adjust priorities. Revenue and expenditure projections cannot be 100% accurate. In the past three budget cycles, unanticipated events, such as the energy crisis and the revenue and expenditure impacts which resulted from the tragedy of September 11, 2001, caused a shift in priorities. None of these issues could have been addressed in a strategic budget plan.

Proposed Budget Principle #8: Once adopted, annual budgets should be amended only when urgency requires, and then by identifying specific funding sources for these new priorities.

This proposed budget principle is already being followed although not as an official budget principle. Mid-year adjustments to the operating budget, including changes to appropriations and the number of budgeted positions, require that City Council pass an ordinance to amend the Annual Appropriation Ordinance. An ordinance requires a 2/3 vote of the City Council. Mid-year adjustments to operating budgets and/or budgeted positions are usually related to emerging Council priorities or mandates.

Adjustments to the Capital Improvements Program (CIP) Budget require that City Council pass a resolution, which requires a majority vote of the City Council. While adjustments to CIP projects are more common, this is generally due to project delays, unforeseen environmental issues, newly identified funding, or amendments to project scope. Proposed mid-year adjustments for both the Operating and Capital Improvements Program Budgets submitted to the City Council require identification of the specific funding sources for the adjustments.

CONCLUSION

The six existing budget principles, with the addition of the two proposed budget principles, will continue to provide a strong foundation to guide budget decision-making and the budget development process and will be implemented incrementally. While it is not always possible to strictly adhere to them, the development of the annual budget is guided by these principles.

ALTERNATIVES

Other alternatives include: 1) adopt the revision to Budget Principle #2, but adopt neither of the Proposed Budget Principles, 2) adopt only the two Proposed Budget Principles, and not the revision to Budget Principle #2, or 3) adopt only one of the two Proposed Budget Principles.

Respectfully submitted,

Lisa Irvine
Financial Management Director

Approved: Michael T. Uberuaga
City Manager

IRVINE/AJC